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TAGS: EFIN ECON EINV PREL PK
SUBJECT: PAKISTAN CENTRAL BANK PROJECTS STRONG ECONOMIC GROWTH IN FY08

Summary

¶1. (SBU) The State Bank of Pakistan (SBP) released its annual report on the state of Pakistan's economy in October 2007 prior to the imposition of the November 3 state of emergency. The State Bank was pleased with the seven percent GDP growth rate in FY2007, particularly given the increase in international oil prices and gradual tightening of monetary policy. The SBP projects that Pakistan's economy will continue to grow strongly in FY08, driven by robust growth in the agriculture and services sectors. The State Bank plans to continue its tight monetary policy, which should contain the demand pressures and check any rapid rise in inflation. Containing inflation, however, may prove difficult because of high international food and fuel prices. While the total stock of debt and liabilities rose, the ratio of total debt and liabilities to GDP continued to decline, one indicator of Pakistan's improved debt servicing potential. Pakistan, however, is likely to face higher debt servicing burden in the future since repayments of the rescheduled non-ODA Paris club debt stock will resume in FY08 and the Euro and Sukuk bonds will mature in FY 2009 and FY 2010 respectively. End summary.

SBP Projects Strong Economic Growth in FY08

¶2. (SBU) The State Bank of Pakistan (SBP) projects that the economy will continue to experience strong, broad-based growth in FY08, particularly in agriculture and services. Continuation of tight monetary policy should help contain demand pressure in the economy, and keep domestic inflation close to the annual target of 6.5 percent in FY08. Key inflation risks are rising international energy prices and the high food commodity prices. The domestic economy was partially insulated from higher international energy prices during FY2007 due to the government's decision not to pass on to customers the increase in the prices of key fuels. This policy will be difficult to sustain if energy prices continue to increase further. Domestic prices for key food staples have already been affected by rising international prices, and domestic food prices will increase further in FY2008 if harvests are below expectations. The SBP expects the current account deficit to be larger than the FY2007 figure in absolute terms. However, the deficit is expected to fall as a share of GDP. A further decline in import growth, together with a small improvement in export growth, and a robust rise in remittances underpins the projected improvement in the current account deficit in FY08. (Comment: Remittances rose 41.5 percent in October 2007, compared to the previous year. End

comment.)

SBP Lauds Investment Led Growth in FY2007

¶3. (SBU) Pakistan's economy recorded one of the fastest growth rates in Asia during FY2007. Real GDP grew 7.0 percent -- surpassed only by China and India. This was the third consecutive year in which growth was supported by rapid rise in real investment. According to the SBP, sound macroeconomic policies have successfully transformed the initial consumption-led growth impetus of a few years back to a greater role for sustainable investment-led growth. With the investment to GDP ratio at a record 23 percent, complemented by a surge in domestic private investment and record FDI flows, the economy looks well-poised to continue on a high growth trajectory in coming years. (Comment: While investment rates are at an all-time high for Pakistan, they are still low compared to China and India. End comment.)

¶4. (SBU) Several key macroeconomic indicators showed substantial improvement in FY2007 compared to FY2006. The national savings percentage of GDP rose from 17.2 percent to 18 percent; the external debt burden declined from 59 percent of GDP to 56.8 percent; and tax revenue increased from 9.5 percent to 9.6 percent of GDP, while the budget deficit stayed at last year's level of 4.3 percent of GDP. The SPB hopes that the improvements in these indicators will lead to increased growth in the coming years.

¶5. (SBU) However, Pakistan still needs to make progress on a number of indicators to ensure sustained economic growth. The current account deficit widened in FY2007; the tax to GDP ratio is still very low at 9.6 percent; and inflation remained stubbornly high at 7.8 percent, showing only a small decline from FY2006. The decline in non-food inflation during FY2006 shows that monetary policy was

effective in containing demand-related inflationary pressures. The impact of the monetary tightening was somewhat overshadowed the higher than anticipated food inflation, which was 10.3 percent in FY2006. Increasing international prices for basic food commodities and failure of domestic crops due to untimely rains contributed to high food inflation.

Quake and infrastructure expenditures increase fiscal deficit
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¶6. (SBU) The fiscal deficit rose to 4.3 percent of GDP, well within range of the 4.2 percent target, despite increases in direct tax collections and non-tax revenues in FY2006. The higher fiscal deficits in FY2006 and FY2007 are mainly attributed to increased spending relief and rehabilitation of the earthquake affected areas. Strong growth in current expenditures also contributed to the rise in the deficit. The GOP's expansionary fiscal policy poses a dilemma. On the one hand, the high fiscal deficit in recent years is driven primarily by development spending, particularly on infrastructure, which is necessary to sustain economic growth. On the other hand, tax reforms have not significantly increased the tax base, even as tax revenues have increased because of sustained economic growth.

The World Bank Categorizes Pakistan as Moderately Indebted
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¶7. (SBU) The SBP report highlighted that Pakistan was classified by the World Bank's Global Development of the Finance as a moderately indebted country in 2006, along with other 38 moderately indebted countries within a group of 211 countries. Pakistan's total stock of debt and liabilities (TDL) rose by 10 percent from FY2006 to FY2007 to reach Rs 5,023.6 billion ($82.35 billion). The growing current account deficit and a large fiscal deficit contributed to this increase. Despite the growth in the TDL stock, the ratio of total debt and liabilities to GDP continued to decline which shows country's improved debt servicing potential. Pakistan has already achieved its FY2013 goal of a 60 percent DL to GDP ratio for FY2007 set out in the 2005 Fiscal Responsibility and Debt Limitation Act.

¶8. (SBU) Pakistan's domestic debt stock increased sharply in FY2007, registering a growth of 11.9 percent - much higher than the average growth of 7.7 percent during the preceding four years. The share of short term debt continued to rise and reached 43 percent in FY2007. The rising share of short term domestic debt means increased vulnerability to adverse short-term interest rate movements, potentially complicating future debt management. There was a sharp rise of 57.1 percent in interest payments on domestic debt in FY2007. The maturing high-cost, zero coupon instruments (domestic saving certificates) issued in late 1990s was the major contribution to this increase.

¶9. (SBU) Pakistan's external debt and liabilities (EDL) rose to US$ 40.1 billion in FY2007, representing a US$2.9 billion increase over FY2006. The rise in the EDL stock included inflows from IDA, ADB, and the issuance of a new Eurobond. Private loans also made sizeable contributions to the increase of the debt stock. Despite this increase Pakistan's EDL to GDP ratio continued to improve. This improvement in debt ratios led to improvements in sovereign ratings; Moody's up-graded Pakistan's foreign and local currency bond ratings to B1 from B2 in FY2007, before downgrading Pakistan following imposition of the November 3 state of emergency

¶10. (SBU) Pakistan continued to move toward longer term financing in FY2007. A significant share of the inflows received during FY2007 had a long term maturity ranging from 15 - 40 years. The improved maturity structure of loan inflows to some extent offsets the effects of the floating interest rate structure of these loans. During FY2007, 62.5 percent of new loan inflows had floating interest rates, including a US$750 million 10-year Eurobond and a substantial portion of Asian Development Bank inflows. A higher share of flexible rate loans might translate into increasing debt servicing burden, should these interest rates rise appreciably.

Resumption of Repayments May Stress Debt Servicing Capacity
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¶11. (SBU) In the coming years, Pakistan is likely to face a higher debt servicing burden as repayments of the rescheduled non-Official Development Assistance Paris Club debt stock will resume in FY2008,

and the Eurobond issued in FY04 and Sukuk bonds issued in FY05 will mature and come due in FY2009 and FY2010 respectively. In addition, interest payments on various Eurobonds issued recently are likely to add to debt servicing burden in coming years. To maintain today's debt servicing capacity, Pakistan's foreign exchange earnings, particularly export earnings, and GDP need to grow faster.

Financial Account Registers Record Surplus

¶12. (SBU) As a result of a relative slowdown in the growth of the current account deficit and a record increase in investment inflows, Pakistan's external account surplus improved substantially to US$3.7 billion in FY2007, compared to US$1.3 billion in FY2006. Moderate growth in the current account deficit is attributed mainly to a sharp fall in the growth of imports (which compensated for an unexpected decline in exports) and a strong increase in remittances (that partially offset the rise in investment income outflows). The financial account surplus increased substantially from US$5.8 billion in FY2006 to a record US$10.1 billion in FY2007. Increased equity flows were largely responsible for this improvement. Pakistan's overall reserves increased by US$ 2.5 billion in FY2007, compared to US$ 524 million in FY2006, one result of the substantial external account surplus.

¶13. (SBU) During FY2007, the Pakistan rupee depreciated by 1.14 percent against the U.S. dollar from July 2006 - January 2007, then appreciated by 0.81% in the second half of FY2007. In the first half of FY2007, the widening trade deficit drove the rupee depreciation while improved market related inflows helped the rupee to regain most of its lost ground later in the fiscal year. The rupee saw a net depreciation of 0.31 percent in FY2007 against the U.S. dollar.

¶14. (SBU) Net dividend and profit outflows were $537 million in FY2007, compared to $433 million in FY2006, for an increase of 24 percent. Telecoms, power, financial services and petroleum refining have recorded heavy profit and dividend outflows because of large foreign investments in these sectors in earlier years. The telecom sector repatriated more profits and dividends, compared to reinvested earnings. The financial services sector reinvested most of its earnings instead of repatriating them in profits and dividends. The heavy FDI inflows in recent years are likely to result in large profit and dividend outflows in coming years unless they are reinvested, putting additional pressure on Pakistan's balance of payments. In FY2007, more than $500 million in profits and dividends left Pakistan.

Comment

¶15. (SBU) The robust growth in the economic activity and prudent management of country's debt has significantly improved debt servicing capacity during the past few years. This is reflected in the fall in the ratio of country's stock of external debt and liabilities (EDL) to GDP from the 57 percent in FY01 to 28 percent in FY2007. Similarly, the ratio of EDL to export earnings also witnessed an impressive fall from the level of 416 percent in FY01 to 237 percent in FY2007, one indication of Pakistan's higher debt repayment capacity.

¶16. (SBU) Notwithstanding these improvements, the sharp deterioration in country's current and fiscal account deficits during the last two years may well limit Pakistan's debt servicing capacity, especially if increases in both the current account and fiscal deficits continue. The resumption of repayment on rescheduled debt and maturing of Euro bonds will put further pressure on Pakistan's debt servicing capacity. The November 3 imposition of a state of emergency is likely to slow foreign investment inflows, and has already driven the rupee to a three year low against the U.S. dollar. Foreign inflows are also likely to fall, due to the political and economic uncertainty, which would be a drag on economic growth. Pakistan is crucially dependent on foreign inflows to support its growth in view of low domestic savings and investment rates. End comment.

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